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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

25 October 1984

MEMORANDUM FOR: (See Distribution)

FROM: [redacted] 25X1
Chief, Strategic Resources Division
Office of Global Issues

SUBJECT: International Oil Prices: The Latest Round

I would like to bring to your attention the attached report prepared by members of my staff concerning recent oil price developments and our view of the problems OPEC will face at its 29 October emergency meeting. [redacted] 25X1

Attachment:
International Oil Prices: The Latest Round
GI M 84-10188, October 1984 [redacted] 25X1

25X1

[redacted]

 25X1

[redacted]

SUBJECT: International Oil Prices: The Latest Round

OGI/SRD/PRB/EMB [redacted] (23 Oct 84) 25X1

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23 October 1984

International Oil Prices: The Latest Round

Summary

The latest series of oil price cuts by Norway, the UK and Nigeria threaten to set off a chain of events that could cause crude oil prices to unravel. OPEC, which is scheduled to meet in an emergency session beginning on 29 October, has indicated that it will attempt to defend the current price structure through production cutbacks. Over the next several months the organization is likely to be aided in its attempt to stabilize the oil market by the increase in seasonal demand which most forecasters expect to materialize soon. Even if OPEC is successful in its current attempt to support oil prices, we believe significant downward price pressure is likely to reappear early next year in the absence of a significant oil supply disruption. Sluggish growth in consumption, increasing output from non-OPEC suppliers and attempts by some producers to maintain market share by price discounts and barter deals will cause continued pressure on oil prices for at least the next one to two years. [redacted] 25X1

This memorandum was prepared by [redacted] Energy Markets 25X1
Branch and [redacted] Petroleum Resources Branch, Office of 25X1
Global Issues. The information contained herein is updated to 23 October 1984. Comments may be directed to [redacted] Chief, 25X1
Strategic Resources Division [redacted]

[redacted] 25X1

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International Oil Prices: The Latest Round

Introduction

The steep decline in non-Communist oil demand since 1979--spurred by price-induced conservation and substitution and compounded by the economic recession of the early 1980s--caused demand for OPEC oil to plummet in recent years. Oil inventory reductions and increased production from non-OPEC producers exacerbated the decline in the demand for OPEC oil. Substantial excess oil productive capacity and competition among producing countries for market share--particularly the North Sea and Nigeria--resulted in the $5 per barrel reduction in OPEC's benchmark oil price in early 1983. Despite OPEC's repeated attempt to reassert control over prices through its production ceiling, the unwillingness of most members to strictly adhere to production and pricing guidelines undermined official prices and led to reductions in Norwegian and British official prices last week. [redacted] 25X1

Nigeria--which produces high quality crude similar to North Sea oil--also cut its oil price to avert a buyer exodus. The Nigerian oil minister's claim that the country could ill-afford such a deterioration in oil exports underscores Lagos's concern that a further decline in oil revenues and worsening economic conditions could have serious political repercussions for the 10-month-old military regime. The Nigerian move has set the stage for an emergency OPEC meeting and once again raises the possibility of a substantial decline in oil prices. While lower oil prices bring economic growth and reduce inflation to oil-importing nations, a substantial price reduction could deal a major blow to debt-ridden oil exporters like Nigeria and Mexico. [redacted] 25X1

The Market Setting

Following a 7.5 million b/d decline in non-Communist oil consumption from 1979 to 1983, free world oil use has increased about 3 percent so far this year--or more than 1 million b/d--over year-earlier levels. [redacted] as much as 25X1 half of this year's consumption increase to special factors, however, such as the coal strike in the United Kingdom and the colder than normal winter of 1983/1984, particularly in North America. At the same time, non-OPEC oil supplies have risen roughly 1 million b/d annually for the last several years. As a result of these factors, OPEC oil output fell from 32 million b/d in 1979 to 18.8 million b/d so far this year--including about 1 million b/d of natural gas liquids. [redacted] 25X1

Against this background of lackluster demand growth and rising non-OPEC output, OPEC members have tried to increase their individual production levels through a variety of price discounting measures that have undermined official OPEC prices.

[redacted] 25X1

Spot oil sales, exports of refined products and natural gas liquids, and the rising number of barter deals have caused buyers to shift purchases away from term deals at official prices. [redacted] recently as much as 50 percent of oil traded has been at other than official prices: 25X1

- Saudi Arabia reportedly will barter about 50 million barrels of crude in payment for 10 Boeing 747 jumbo jets, according to the US Embassy. Press reports indicate that the UAE will exchange 40,000 b/d of oil with France for 18 Mirage 2000 fighters. Qatar has trade-linked oil swaps with Japan, France, and South Korea for equipment and construction work on desalinization plants, according to press reports. Libya also barters much of its crude. [redacted] 25X1

[redacted]

- Iran and Iraq offer price discounts to maintain commercial ties with customers. Iran pays for war risk insurance and Iraq has been forced to spot market sales at prices about 50 cents per barrel below official levels to dispose of its crude. [redacted] 25X1

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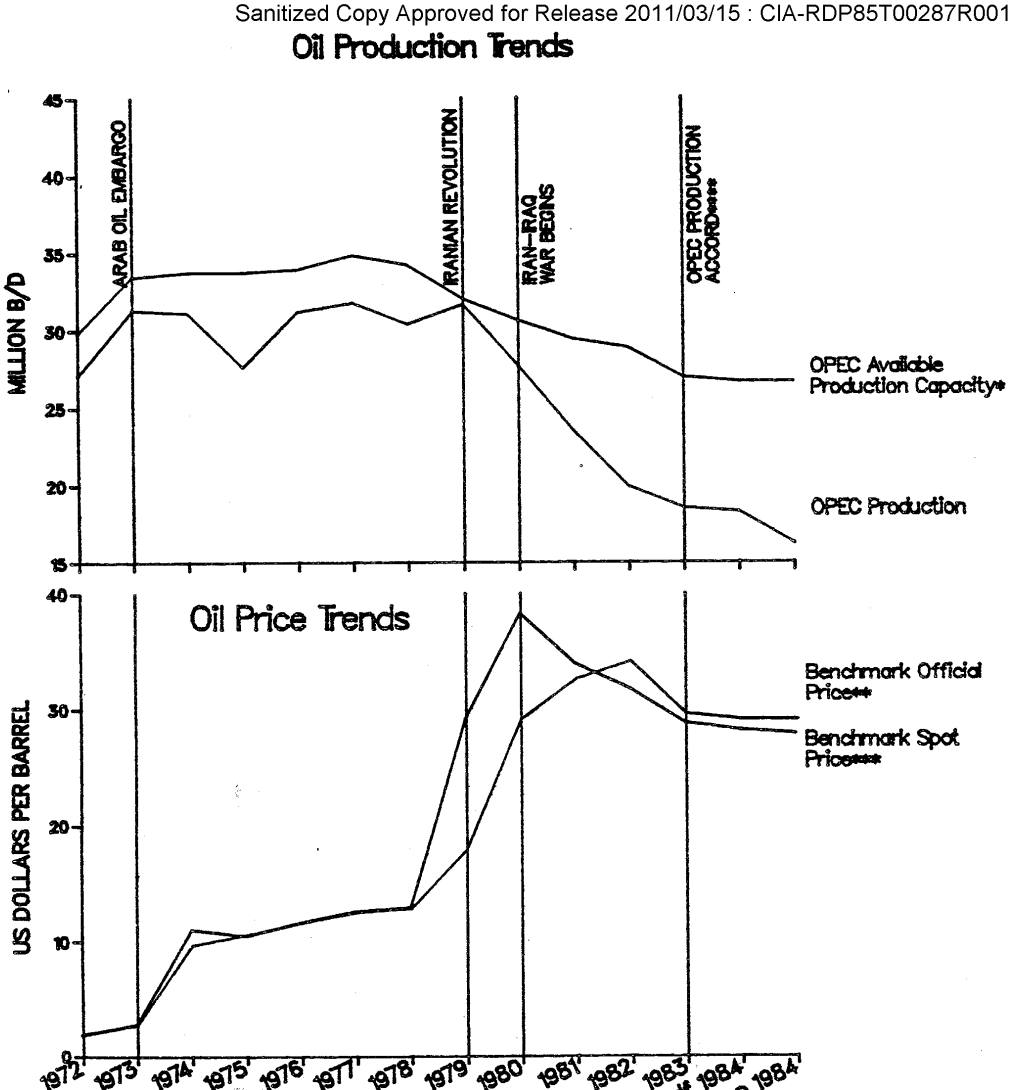
[redacted]

As a result of these effective price discounts, spot oil prices have consistently been at least $1 to $2 per barrel below official levels this year. Because of excess OPEC production, spot prices were especially weak in late July and early August--temporarily falling to as much as $3 per barrel below official levels for light crudes (Figure 1). Although the United Kingdom

[redacted] 25X1



* Reflects government production ceilings.
** Actual contract sales prices for Arabian Light.
*** Annual average.
**** Benchmark price falls $5/bbl.

was under severe pressure to reduce its official prices, London formally requested oil companies operating in the UK to cooperate with the British National Oil Company (BNOC) to weather the "temporary" market weakness, according to embassy reporting. As a result, London managed to hold the line on prices in July, but BNOC lost additional contract sales and the company was forced to sell about 300,000 b/d of oil at spot prices. 25X1

The rising supply of light crude production in recent years and the ready availability of crudes on a spot basis--particularly from the North Sea in 1983 and 1984--at a time of falling refiner demand for lighter crudes has especially weakened prices of what traditionally have been considered premium oils. Light crudes yield greater proportions of light petroleum products such as gasoline. Investments to upgrade refineries, however, now allow processing of less expensive heavy crudes and the use of heavy refined product as feedstock. As a result, demand for less costly heavy crudes has increased at the expense of light crudes even though demand for light products remains relatively strong. Currently, the offical price differential between Arab Light--the OPEC benchmark--and Arab Heavy crude is $3 per barrel[1]. The relative value of these crudes to refiners in recent weeks, however, indicates that the market differential approximates only $1 per barrel. OPEC members have recognized and studied this problem, but the issue has proved extremely difficult to resolve. 25X1

Recent Price Developments

Norway's decision to reduce its oil prices--made public on 16 October--apparently resulted when the Norwegian state oil company was threatened with contract terminations because of the high official price relative to spot prices. According to embassy sources, the Norwegian price reduction came as a shock to the British. Because the UK produces crude similar to Norway--in two cases, identical crude--London was forced to follow the Norwegian cut. BNOC advised its customers of a $1.35 per barrel price reduction on 17 October, citing Norway's price drop as well as an effective $.50 reduction in the Saudi oil price. Saudi Arabia had previously announced a change in its export mix--increasing the proportion of heavy crude--and, although some analysts speculate Riyadh was attempting to shore up light crude prices by reducing total availability, many industry observers read the change in the Saudi mix primarily as a price cut. Prior to the North Sea price cuts, the pressure on light oil prices was made apparent when the UAE oil minister threatened to

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[1]Differentials are the margins by which prices of various crudes differ from the price of the OPEC benchmark crude--Saudi Arab Light 34° API. These differences reflect variations in crude quality and proximity to major markets. 25X1

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unilaterally reduce official prices by about $.50 per barrel. Recent public statements by the UAE minister now indicate official prices will not change--at least until after OPEC meets. [redacted] 25X1

Spot oil prices declined an additional $.30 to $2 per barrel over the last week. In our judgment, most of this decline is due to buyer hesitancy to purchase oil until price trends become clearer; [redacted] most of the recent decline 25X1 in spot prices is due to speculative trading. [redacted] 25X1

Nigeria's Reaction

Events of the last week closely mirror developments of early 1983 when a British price cut, coupled with a precipitous drop in Nigerian production, triggered a $5.50 per barrel reduction in Nigeria's official price. Nigeria's unilateral action led to an unprecedented drop in the OPEC benchmark price from $34 to $29 per barrel. The price cut did little, however, to spur demand for Nigeria's crude and we believe the continued downturn in oil exports caused a further deterioration in domestic economic conditions and played a part in the ouster of Nigeria's civilian government in December 1983. In 1984 the new military regime appealed to OPEC for relief and, in July, the organization granted Lagos a temporary reprieve by increasing Nigeria's OPEC-mandated production quota for August and September. [redacted] 25X1

When oil production fell short of target as a result of weak demand and overproduction by other OPEC members, Lagos's stop gap effort to address the country's financial plight with additional oil earnings was thwarted. Even though Lagos recently offered to begin paying interest on its $2-$3 billion in officially guaranteed short-term debt, according to embassy reporting, Nigeria remains saddled with more than $4 billion in debt service on medium and long term obligations and a $6 billion current account deficit. Lagos's growing inability to meet minimum import needs and its unwillingness to agree to a rigorous and unpopular IMF loan agreement forced Nigeria to resort to agressive marketing tactics--including hidden price discounts and bartering--to move its oil. While these tactics spurred September's oil output to levels commensurate with Nigeria's new OPEC allocation, recent industry reporting suggests that Nigeria's oil production began to slide two weeks prior to Lagos's announced price cut. [redacted] 25X1

The Nigerian price drop of $2 per barrel undercuts UK and Norwegian prices by 65 cents, and in our judgment reflects an attempt by Lagos to gain a competitive advantage over North Sea crudes. The move also puts severe downward pressure on other exporters of light crude. [redacted] 25X1

Under present circumstances, Nigeria's perceived self-interest conflicts with OPEC's attempts to maintain the current benchmark price, and, despite recent public statements by Lagos of OPEC solidarity, calls into question Nigeria's commitment to OPEC guidelines. Lagos's latest price move seriously threatens OPEC's official price structure and will further test the organization's cohesion. [redacted] 25X1

OPEC's Options

OPEC's ability to forestall a price break is in serious jeopardy. Saudi Oil Minster Yamani called a "crisis" strategy meeting in Geneva on 22 October with the oil ministers of at least five other OPEC members and--in an unprecedented move--with representatives from two non-OPEC oil exporting nations, Mexico and Egypt, also in attendance. The strategy meeting precedes a full ministerial emergency meeting slated for 29 October. We believe OPEC has several options available to it as the organization seeks to address the difficult issues that confront it on prices and production:

- OPEC could attempt to buoy the market by lowering its current 17.5 million b/d production ceiling or simply cut production below existing levels. The Libyan oil representative publicly announced after a strategy session earlier in the week that OPEC is leaning toward a reduction in current production quotas. [redacted] 25X1 the US embassy reports that Venezuela probably is able to restrict output by 75,000 b/d. Press reports indicate that Libya also may be willing to reduce output to defend prices. [redacted] 25X1 25X1

- OPEC could try to obtain an agreement from members to limit light oil production. This approach would at least temporarily address the problem of excess availability of light crude oil. [redacted] 25X1

- OPEC could tackle the differential problem and opt to realign differentials by raising the price of the more attractive, heavier crudes. The differential issue is a thorny and difficult one to resolve but an increase in the price of heavy crudes could help avert an official price break. Over the long-term the relative prices of light and heavy crudes will have to be realigned to reflect market realities. [redacted] 25X1

- OPEC could again agree to reduce official prices. Members certainly realize, however, the danger of a price cut to their economies and the risk of touching off a futher unraveling of prices. [redacted] 25X1

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- The organization could appeal to Nigeria to raise its price and to abide by OPEC guidelines. Although Nigeria might agree, a hefty financial incentive or a substantial increase in its production quota probably would be necessary to encourage Lagos to rescind its price cut. Because Nigeria failed to attend the strategy session, Saudi Oil Minister Yamani visited Lagos this week. [redacted] 25X1

- OPEC may be forced to give up hope of Nigeria's cooperation and close ranks to avoid a general price decline by accepting even deeper production cuts. [redacted] 25X1 Although there may be some sentiment in Nigeria against remaining in OPEC, on balance we believe Lagos would prefer to retain the prestige afforded by OPEC membership. [redacted] 25X1

Whatever option it chooses, OPEC will need to show strong and perhaps uncharacteristic cohesion. Because competing interests have divided OPEC in the past, any short-term solution could raise major problems within the organization as members jockey to maintain market share. In our view, measures to avert a price slide by cutting output and waiting for colder weather to spur demand are short term in nature and do not effectively solve the problems caused by the sharp decline in demand for OPEC oil. [redacted] 25X1
[redacted] 25X1

The Outlook

[redacted] 25X1 OPEC's success in maintaining the benchmark in the immediate period depends on members' ability to lower output in line with market requirements. The expected seasonal increase in oil demand could temporarily ease the need for the organization to substantially reduce output; industry sources continue to anticipate an increase of about 1.5 to 2 million b/d in demand for OPEC oil in the fourth quarter. Some OPEC members, however, have become skeptical of these estimates in recent weeks. The OPEC Secretariat's estimate of demand for OPEC oil in the fourth quarter of this year is 18.3 - 18.5 million b/d, 500,000 to 1 million b/d below industry estimates. At the same time, however, oil inventories are unusually low given the time of year according to our analysis; preliminary data suggests oil stocks may have declined as much as 500,000 b/d in the third quarter compared to a normal seasonal build in inventories of about 2 million b/d. As a result, we doubt companies are in a position to attempt to stretch inventories much further to meet seasonal needs. [redacted] 25X1

Even if OPEC manages to hold prices together now, we believe price pressures are likely to recur over the near-to-medium

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term. Most industry analysts project the underlying growth rate in non-Communist oil consumption at only about one percent per annum. As a result, if non-OPEC oil production continues to climb in the next few years--as we expect--demand for OPEC oil could continue to stagnate. Those members of OPEC who are financially strapped--especially Nigeria, Venezuela, and Indonesia--will find it increasingly difficult to justify austerity measures to their population in the hope of an ever distant rise in oil revenues. In addition, opportunities for circumventing official prices--such as the sale of refined oil products at prices tied to the spot market--will increase. Saudi Arabia alone is expected to be marketing as much as 500,000 b/d of refined products by 1986. Plans to increase Iraqi oil export capacity also suggest that means to accommodate at least 500,000 b/d of additional output from Iraq must be found. As a result, we believe OPEC again will be confronted with the need to defend oil prices, possibly in early 1985, and the organization's ability to carry out such action probably will be lessened. 25X1

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Appendix 1

Oil Price Pressures: The 1984 Situation

Pressure on official oil prices is not a new experience for OPEC. Indeed, the organization is facing its third oil price "crisis" within the past 12 months. Although the sequence of events in recent weeks is similar to events that led to the $5 per barrel reduction in the benchmark oil price in early 1983, oil market conditions differ in a number of ways:

- Non-Communist oil consumption has increased about 3 percent so far this year, while oil consumption in 1982 and 1983 declined 3 percent and 2.5 percent, respectively, from year-earlier levels.

- The level of excess oil inventories has declined sharply. We estimate primary oil stocks on land currently approximate 4 to 4.1 billion barrels--88 to 89 days of non-Communist oil consumption in the current quarter--and our analysis indicates excess commercial stocks accumulated earlier in the year have been depleted. In early 1983, primary oil stocks were 4.3 to 4.4 billion barrels and stock reductions in the first quarter of 1983 approximated 4 million b/d.

- OPEC has been somewhat more successful in recent months in restraining oil output with production averaging 17.2 million b/d in September, including 1 million b/d of natural gas liquids.

- Spot oil prices were about $1.80 per barrel below official prices for Arab Light and spot prices for Nigeria's Bonny Light crude were equal to its new official price late last week. In early 1983, spot prices for Arab Light and Bonny Light were $4 and $5 per barrel below official levels, respectively.

- Some non-OPEC oil producers are cooperating more closely with the organization to support official prices. According to press reports, Egypt--which had previously cut official prices during weak market periods to match spot prices--has publically appealed to all exporters to cooperate to prevent a fall in oil prices. Because of a price cut by the USSR earlier in the year, Soviet prices are roughly in line with spot prices without further changes.

- Last year, Saudi rhetoric indicated Riyadh supported an OPEC price cut--claiming that it would be inevitable if North Sea producers and Nigeria cut prices.

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[redacted]

Appendix 2

OPEC--Non-OPEC Cooperation

At its July ministerial meeting, OPEC agreed to launch an unprecedented mission by Saudi Oil Minister Yamani to several non-OPEC oil-exporting countries to examine the possibility of increased cooperation. The initiative to coordinate long-term strategy efforts with non-OPEC countries reflects disquiet within OPEC about the loss of market share to non-OPEC producers. Some OPEC members openly are critical of the recent surge in North Sea production and industry sources speculate that the organization could place a special tariff on manufactured goods from non-OPEC countries that refuse to cooperate with OPEC. [redacted] 25X1

Less developed oil exporters have, for the most part, accommodated OPEC's wishes. Mexico has implemented a self-imposed export limit [redacted] 25X1

While non-OPEC less developed countries appear to be more willing to follow OPEC's lead, the organization has had minimal success in getting the UK, Norway and the Soviet Union to cooperate. Yamani visited London in August and industry speculation that the meeting resulted in a letter urging producers to maintain price stability brought a public outcry. In our judgment, Yamani's visit may have been to provide London of an accurate estimate of Saudi output. The UK has repeatedly vowed that it will not reduce production to help OPEC maintain prices. Norway's price cut--on the heels of an invitation to attend an OPEC Monitoring Committee meeting--raised questions about the success of Yamani's mission. OPEC's president recently stated that the Soviets are "in solidarity with OPEC". The USSR however, has traditionally adjusted prices to reflect market conditions rather than reduce production or exports. [redacted] 25X1

[redacted] 25X1

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